Board of Governors of the Federal Reserve System

REPORT ON THE FAILURE OF GUARDIAN BANK

OFFICE OF INSPECTOR GENERAL

(A9608) **October 1996**

October 7, 1996

The Honorable Alan Greenspan
Chairman

We are pleased to present our final *Report on the Failure of Guardian Bank* (Guardian). Our Federal Deposit Insurance Act-mandated review found that Guardian failed primarily as a result of inadequate management oversight of an aggressive growth strategy that was funded with volatile and unstable deposits in a declining California economy. Our inquiry as to why the initial loss estimate more than tripled led the Federal Deposit Insurance Corporation's Division of Resolutions to address changing procedures to avoid omitting non-asset-specific receivership expenses in its initial loss estimates.

We determined that the level of supervisory actions taken with Guardian were within the range of acceptable actions for the problems they experienced and that recent changes in the Reserve Bank of San Francisco's staffing, organization structure, and procedures and improved policy guidance from the Board have strengthened the examination process and should help examiners identify problems sooner and perhaps prevent some of the problems that led to Guardian's failure. Consequently, we are not making any formal recommendations as a result of this review. We will, however, continue to assess the long term effectiveness of these supervisory changes, and will make warranted recommendations.

The deputy director of the Division of Banking Supervision and Regulation indicates agreement with our analysis of the problems that led to the material loss. In addition, he is hopeful that the policy initiatives that have been adopted by the Board will help enhance and streamline the supervision and examination processes going forward.

We will respond to any questions you or other members of the Board may have. The full report is available to the public and copies are being provided to the Comptroller General of the United States, the Chairman of the Federal Deposit Insurance Corporation, and the California State Banking Commissioner. A summary will appear in our semiannual report to Congress.

Sincerely,

Brent L Bowen
Inspector General

Enclosure

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EXECUTIVE SUMMARY

On January 20, 1995, the California State Banking Department closed Guardian Bank (Guardian), a state member bank of the Federal Reserve System headquartered in Los Angeles, California. Currently, the Federal Deposit Insurance Corporation (FDIC) estimates that Guardian's failure will result in a $30 million loss to the FDIC's Bank Insurance Fund. As required by section 38(k) of the Federal Deposit Insurance Act, the Office of Inspector General of the Board of Governors of the Federal Reserve System (the Board) conducted a review of the Federal Reserve's supervision of Guardian to (1) ascertain why the institution's problems resulted in a material loss to the insurance fund and (2) make recommendations for preventing any such loss in the future.

Guardian failed as a result of its management's inadequate oversight of an aggressive growth strategy that was funded with volatile and unstable deposits. The bank concentrated its lending activities in real estate and construction/land development loans but did not have the supporting underwriting and loan administration practices to compensate for the inherent risks of these assets. Further, because the bank relied on escrow and title company accounts as its core deposits but lacked the appropriate management information systems and asset/liability processes to control periodic fluctuations, it had constant liquidity problems and high interest rate risk. When the southern California economy declined, borrowers could not adequately service their loans; the dramatic growth in loan losses and reserves for losses resulted in a drain on the bank's income and earnings. As the major depositors became increasingly aware of Guardian's deterioration, the bank experienced large deposit withdrawals that ultimately required the bank to borrow from the Federal Reserve Bank of San Francisco's (Reserve Bank) discount window to stay in operation. When the Reserve Bank determined that it was imprudent to continue lending to Guardian, these loans were called. The bank was unable to repay the loans, became insolvent, and was closed.

We believe that the level of supervisory actions taken by the Federal Reserve was within the range of acceptable actions to address the problems experienced by Guardian. While the conditions that led to Guardian's failure were identified and addressed in the written agreement entered into between Guardian and the Reserve Bank on October 14, 1992, the actions taken were unable to prevent the decline in asset quality or the erosion of deposits. Although it appeared that the Reserve Bank conducted examinations of Guardian with the appropriate frequency required by Board policy, the State examination accepted by the Federal Reserve in 1990 was limited in nature, did not include a review of credit files, and did not qualify as a full-scope examination. Nevertheless, it is impossible to determine if there would have been any effect on the fate of Guardian or on the loss to the insurance fund had a full-scope examination been conducted, since a significant portion of loan growth occurred subsequent to that examination.

The supervision relating to Guardian and its problems occurred during the same time period that the Reserve Bank's staffing and organization structure was changing and the Board was providing improved policy guidance. For example, the Reserve Bank now assigns one person to monitor and oversee specific banks and has executed a regional agreement implementing a state/federal supervisory protocol which, among other things, promotes seamless, flexible, and risk-focused examinations to minimize regulatory burden and expense. The Federal Reserve has supplemented its techniques for off-site monitoring between on-site examinations and has begun implementation of a risk-focused approach to concentrate its examinations on areas that pose the greatest risk to financial institutions and to adopt supervisory processes that respond to these risks. In addition to internal changes within the Federal Reserve, the passage of the Federal Deposit Insurance Corporation Improvement Act in 1991 has done much to address problems similar to the causes of Guardian's failure and to strengthen supervisory practices.

We endorse these efforts to improve the supervisory process and do not have any formal recommendations regarding the supervisory practices for preventing future material losses to the deposit insurance fund as a result of this material loss review. However, it is difficult to assess the current impact or long-term effectiveness of these supervisory changes during this single review. As we perform additional material loss reviews and as part of our regular program audits of the supervision of state-member banks; we will evaluate these changes and make recommendations if warranted.